AMERICAN ACADEMY of ACTUARIES

Ms. Stephanie Weakley
Director, Office of Resource Management
U.S. Department of Energy
1000 Independence Avenue SW
Washington, D.C. 20585

May 10, 2007

Subject: Request for Public Comment on Pension and Medical Benefits

Dear Ms. Weakley:

The Pension Committee of the American Academy of Actuaries[1] appreciates the opportunity to offer comments on the issues faced by the Department of Energy (DOE) and its contractors in managing the costs of "pension and medical benefits." We understand the DOE's need to control cost, and we acknowledge the recent increases in DOE costs. However, we are concerned that the issues facing the DOE in these matters are being obscured. As such, we ask that you consider the following:

Plan Design

The long-term cost of any retirement plan is a function of the level of the benefits, not whether it is a defined benefit (DB) or a defined contribution (DC) plan.

Defined benefit plans are sometimes perceived as more expensive than defined contribution plans. This is a flawed perception because the benefit levels of the plans are usually not comparable. A DB plan that costs more than a DC plan is likely to provide much higher benefits. If a DB plan and a DC plan have the same long-term cost, the DB plan is likely to provide better retirement benefits, although the DC plan may provide better termination benefits for short-term employees. The better retirement benefits of the DB plan are the result of certain cost efficiencies, primarily the pooling of the longevity risk that creates value and provides lifetime benefits at a much lower cost than DC plans, and the higher investment returns typically obtained by professional defined benefit plan

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession

asset managers investing large amounts compared to the average defined contribution plan participant[2].

We agree that the contractor's cost of the retirement program should be market competitive. A plan's competitiveness should be evaluated based on long-term anticipated costs. In addition, given an acceptable cost level, the design of the plan, should still be determined by the contractor.

We understand that assessing the long-term cost of a defined benefit plan is not always clear. When the plan's actual experience falls short of the actuarial assumptions used during the procurement process, the actual plan costs will increase over what was initially projected—sometimes dramatically so. We note that the DOE has qualified actuaries who are capable of assessing whether the assumptions are reasonable, and assisting in determining comparability of pension design between competing bidders. We suggest that instead of restricting plan design, DOE should instead require review of actuarial assumptions, particularly those relating to:

- Investment return;
- Current mortality rates and expected improvements in mortality;
- Anticipated salary increases; and
- Early retirement.

For retiree medical benefits accruals, we suggest review of claim-cost assumptions, including trend rates and aging factors

Definition of Cost

The DOE has observed that reimbursements since FY 2000 have increased by 226 percent. However, we note that the costs in FY 2000 probably understated the true costs of the plans, and are thus an inappropriate starting point for comparing costs. In addition, the period chosen is unlike any other in DB funding history, due to a severe market crash, falling interest rates, and problems in the minimum funding rules (e.g., the deficit reduction contribution rules, which have been fixed). In any other period there would have been much different results.

Under the DOE's policy, sponsor contributions to the plan and DOE reimbursements to the sponsor are both based on minimum funding requirements, which can vary above and below the true long-term cost of the plan. DOE could use alternative approaches to determine reimbursements that would better reflect the true cost of the plan and be less volatile. For example, reimbursements to 100 percent funded plans could be set at the value of benefits earned each year (a relatively consistent amount) rather than the

---

[2] Furthermore, if a DB plan sponsor is considering a DC plan in order to provide more benefits to young, mobile employees (and less benefits to older employees), there are other options that can be explored that take advantage of the higher investment returns within DB plans. For example, cash balance DB plans can provide the same benefits as a self-funded DC plan, but at a lower expected cost due to the investment efficiencies discussed earlier.

minimum contributions. We would be pleased to work with the DOE in developing other acceptable approaches.

Volatility

In addition to overall cost levels, DOE has expressed concern about the volatility of those costs. Given the needs of government, which include the need to budget, we understand that DOE may seek measures that will control volatility. Use of stable, reasonably conservative actuarial assumptions as previously described will help control volatility, as will adoption of a reimbursement policy more stable than minimum contributions. In addition, a substantial portion of the perceived volatility arises from insufficient asset/liability matching. To address this, the DOE could consider requiring contractors to utilize strategies (e.g., equity linked benefits or interest sensitive investments) that can largely eliminate this volatility. Also, in some specific situations, contractors may be able to control volatility through restructuring certain benefit provisions.

We believe that sound policy requires that the DOE specify the outcomes they need (e.g., limited volatility and cost) rather than try to define the products (i.e., type of plan) that may or may not accomplish DOE's goals.

Practical Issues

The preceding parts of this letter described some of what we believe to be the theoretical underpinnings of an appropriate pension reimbursement policy. Furthermore, forcing contractors to adopt a defined contribution plan for new employees has practical problems as well, including the following:

- Defined contribution plans generally focus a greater proportion of the benefit dollar on younger, short-service employees. By using defined contribution plans for new employees, contractors will either have to increase overall costs (obviously not what the DOE wants) or significantly decrease retiree benefits.
- It is widely known that DOE contractors are faced with the challenge of attracting and retaining experienced employees in high-skill positions. Defined benefit plans are an effective attraction and retention tool for those types of employees. Eliminating defined benefit plans may force contractors to increase pay to replace the attraction/retention advantages, thus resulting in higher costs to the DOE, even if the replacement DC plan is cost neutral.
- Administering two plans is more expensive than administering one. The dual administration costs, including the need to avoid IRS plan discrimination issues, continue for many years.
- A dual plan structure results in employees working side by side with different benefit plans. This can easily lead to morale problems, which result in lower productivity or higher turnover, both of which again would create cost issues for DOE.
- Because volatility is tied to benefits already earned, changing benefits for future service will likely have a very minimal effect on volatility over the next decade or

more. The other items mentioned in this letter would be much better at controlling volatility.

- Workforce management is more difficult under DC plans. Instead of the relatively consistent patterns of retirement one sees with a DB plan, employees in DC plans will be more apt to retire in droves when the stock market is doing exceptionally well and may not opt to retire at all when the stock market is doing poorly. If the contractor's business needs do not match this pattern, significant payroll/training cost inefficiencies can occur. DB plans also improve workforce management by allowing employers to create retirement incentives/disincentives. This is not similarly possible with DC plans, particularly with the many employees who have not contributed enough to the 401(k) arrangements.

Summary

Volatility and levels of pension cost are significant business issues. However, prohibiting certain plans will not control volatility, but will exacerbate problems as contractors will have increased costs, may be unable to retain workers and may have more difficulty managing the turnover of their workforce. Solutions can be developed that will meet the needs of the DOE, contractors, and their employees.

The DOE could examine how it defines reimbursable costs, and consider requiring contractors to maintain plans that control the growth and volatility of pension and retiree medical costs by using appropriate funding policy, investment policy, and plan design. Financial incentives and penalties could be incorporated into contracts to support these policies.

We appreciate this opportunity to share our concerns on the issues the DOE faces with contractor costs related to pensions. We would appreciate the opportunity to meet with you in order to answer any questions you may have or to discuss any of the concerns expressed within this letter. If you have any specific questions or would like more information, please contact Samuel Genson, the American Academy of Actuaries' pension policy analyst, at 202-223-8196. Thank you for your consideration of this matter.

Sincerely,

James F. Verlautz, FSA, EA, MAAA, FCA
Chairperson, Pension Committee
American Academy of Actuaries